

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Machado Analyst: John Pavalasky Bill Number: SB 1713  
Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: February 20, 2004  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Conformity To The Military Family Tax Relief Act Of 2003 (MFTRA)

### SUMMARY

This bill would conform California law to the changes made by the federal MFTRA.

### PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to improve tax equity for military personnel by making state law the same as the federal MFTRA that was enacted on November 11, 2003.

### EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately and apply as specified in each provision.

### POSITION

Pending.

### SUGGESTED AMENDMENTS

This bill contains provisions that are operative for transactions and taxable years beginning before January 1, 2004. However, the bill does not provide a public purpose statement for the operative dates of the relief provided by the bill. Attached is language to provide a public purpose statement for the operative dates of the relief provided by the bill. In addition, a technical amendment is provided to correct a cross-reference to the Internal Revenue Code.

### ANALYSIS

The bill contains the following provisions:

1. Exclusion of Gain on Sale of a Principal Residence by a Member of the Uniformed Services or the Foreign Service.
2. Exclusion from Gross Income of Certain Death Gratuity Payments.
3. Exclusion for Amounts Received Under Department of Defense Homeowners Assistance Program.

#### Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

#### Department Director

#### Date

Gerald Goldberg

March 19, 2004

4. Expansion of Combat Zone Filing Rules to Contingency Operations.
5. Modification of Membership Requirements for Exemption from Tax for Certain Veterans' Organizations.
6. Clarification of Treatment of Certain Dependent Care Assistance Programs Provided to Members of the Uniformed Services of the United States.
7. Treatment of Service Academy Appointments as Scholarships for Purposes of Qualified Tuition Programs and Coverdell Education Savings Accounts.
8. Suspension of Tax-Exempt Status of Terrorist Organizations.
9. Above-the-Line Deduction for Overnight Travel Expenses of National Guard and Reserve Members.
10. Extension of Certain Tax Relief Provisions to Astronauts.

Attachment I is a table that summarizes the ECONOMIC IMPACT of each provision. Attachment II contains a detailed discussion of each provision of the bill.

## LEGISLATIVE HISTORY

AB 1073 (Dutton, et al., 2003/2004) would exclude from tax the death gratuity paid to the survivor of a deceased member of the Armed Forces of the United States. This bill is currently in the Senate Revenue and Taxation Committee.

## OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. None of the states surveyed has enacted statutes that conform to the MFTRA.

## ARGUMENTS/POLICY CONCERNS

The MFTRA made the exclusion of gain on sale of a principal residence effective as if included in the Taxpayer Relief Act of 1997, and allowed a one year period (i.e. until November 11, 2004) for filing amended returns for any years otherwise closed on November 11, 2003. This bill would make the California provision effective for the same periods. However, the practical effect of California using the same cut-off date as federal (i.e. only until November 11, 2004) would be to provide a potentially very short period for filing those amended returns. The author may wish to provide a later cut-off date for California amended returns, such as six months to a year from the date of enactment of this bill.

## LEGISLATIVE STAFF CONTACT

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**ATTACHMENT I**  
ESTIMATED REVENUE IMPACT OF CONFORMITY TO P.L. 108-121,  
THE "MILITARY FAMILY TAX RELIEF ACT OF 2003,"  
AS ENACTED NOVEMBER 11, 2003  
[Millions of Dollars]

Provision	Effective	Fiscal Years		
		2003-04	2004-05	2005-06
Provisions to Improve Tax Equity for Military Personnel				
1. Exclusion of gain on Sale of Principal Residence by a member of the Uniformed Services or the Foreign Service (IRC 121)	soea 5/6/97	-2	-0.5	-0.5
2. Exclusion from Gross Income of Certain Death Gratuity Payments (IRC 134)	doa 9/10/01	negligible	negligible	negligible
3. Exclusion for Amounts Received Under Department of Defense Homeowners Assistance Program (IRC132)	pma DOE	negligible	negligible	negligible
4. Expansion of Combat Zone Filing Rules to Contingency Operations (IRC 7508)	[1]	negligible	negligible	negligible
5. Modification of Membership Requirement for Exemption from Tax for Certain Veterans Organizations (IRC 501( c )(19))	tyba DOE	negligible	negligible	negligible
6. Clarification of Treatment of Certain Dependent Care Assistance Programs Provided to Members of the Uniformed Services of the United States (IRC 134)	tyba 12/31/02	no impact	no impact	no impact
7. Treatment of Service Academy Appointments as Scholarships for Purposes of Qualified Tuition Programs and Coverdell Education Savings Accounts (IRC 529 and 530)	tyba 12/31/02	negligible	negligible	negligible
8. Suspension of Tax-Exempt Status of Terrorist Organizations (IRC 501)	dmbo/a DOE	negligible	negligible	negligible
9. Above-the-Line Deduction for Overnight Travel Expenses of National Guard and Reserve Members (IRC 162)	apoia 12/31/02	-2.5	-2.3	-2.3
10. Extension of Certain Tax Relief Provisions to Astronauts (IRC 101, 692, and 2201)	[2]	negligible	negligible	negligible
Total		-4.5	-2.8	-2.8

Negligible = \$50,000 or less

Legend for "Effective" column:

apoia = amounts paid or incurred after  
doa = deaths occurring after  
pma = payments made after  
DOE = date of enactment

soea = sales or exchanges after  
dmbo/a = designations made before, on, or after  
tyba = taxable years beginning after

[1] The provision applies to any period for performing an act that has not expired before the date of enactment.  
[2] Generally effective for qualified individuals whose lives are lost in the line of duty after December 31, 2002.

## ATTACHMENT II – DETAILED DISCUSSION OF EACH PROVISION

### **1. Exclusion of Gain on Sale of a Principal Residence by a Member of the Uniformed Services or the Foreign Service.**

#### FEDERAL/STATE LAW

Under prior federal law and current California law, an individual taxpayer may exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the date of sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or to the extent provided under regulations, unforeseen circumstances, is able to exclude an amount equal to \$250,000 (\$500,000 if married filing a joint return) multiplied by the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to the members of the uniformed services or the Foreign Service of the United States.

#### New Federal Law

The MFTRA provides that an individual may elect to suspend for a maximum of ten years the five-year test period for ownership and use during certain absences due to service in the uniformed services or the Foreign Service of the United States.

The uniformed services include:

- the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard);
- the commissioned corps of the National Oceanic and Atmospheric Administration; and
- the commissioned corps of the Public Health Service.

If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to ten years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services or of the Foreign Service of the United States.

For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in Government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

#### Effective Date

This MFTRA provision is effective for sales or exchanges made after May 6, 1997. The act provides a one-year period (beginning on November 11, 2003) for taxpayers to claim refunds as a result of this provision that are otherwise barred by the statute of limitations.

### Current California Law

California law, as it relates to the exclusion of gain from the sale of a principal residence, is generally in conformity with federal law as it read prior to the enactment of the MFTRA. Additionally, California law also specifically reduces the required two-year occupancy period by up to six months for any time the taxpayer served in the Peace Corps.

### THIS BILL

This bill would conform to the MFTRA changes to this provision. The federal provision was made effective as if included in the Taxpayer Relief Act of 1997 and this bill would make the California provision effective for the same periods. Consistent with other elections under this provision, a taxpayer's election to suspend the period of ownership and use for federal purposes would be binding for California purposes.

### **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

### **ECONOMIC IMPACT**

#### Revenue Estimate

Estimated Revenue Impact for Exclusion of Gain on Sale of Principal Residence by a Member of the Uniformed Services or the Foreign Service For Sales or Exchanges Made After May 6, 1997 (\$ Millions)			
Fiscal Year	2004-05	2005-06	2006-07
Revenue Loss	-2	-0.5	-0.5

#### Revenue Discussion

Revenue estimates were based on federal projections.

### **2. Exclusion from Gross Income of Certain Death Gratuity Payments.**

#### FEDERAL/STATE LAW

Under prior federal law and current state law, qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) that:

- is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and
- was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice that was in effect on that date.

Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income. Qualified military benefits include certain death gratuities with the level of the death gratuity exclusion set at \$3,000 since September 9, 1986. The amount of the military death gratuity benefit has been increased since September 9, 1986, to \$6,000 pursuant to Chapter 75 of Title 10 of the United States Code, however, the amount of the exclusion from gross income was not increased to take into account this change.

#### New Federal Law

This provision increases the amount of the death gratuity payable under Chapter 75 of Title 10 of the United States Code to \$12,000. Also, the provision extends the exclusion from gross income to any adjustment to the amount of the death gratuity payable under Chapter 75 of Title 10 of the United States Code that is pursuant to a provision of law enacted after September 9, 1986, with respect to the death of certain members of the Armed Services on active duty, inactive duty training, or engaged in authorized travel. Therefore, the amount of the exclusion is increased to \$12,000.

#### Effective Date

The provision is effective with respect to deaths occurring after September 10, 2001.

#### Current California Law

California law, as it relates to the exclusion from gross income of certain death gratuity payments, is in conformity with federal law as it read prior to the enactment of the MFTRA.

#### THIS BILL

This bill would conform to the MFTRA changes to this provision. The federal provision was made effective with respect to deaths occurring after September 10, 2001, and this bill would make the California provision effective with respect to deaths occurring after September 10, 2001.

#### **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

#### **ECONOMIC IMPACT**

##### Revenue Estimate

Conforming to the federal exclusion of certain death gratuity payments from gross income would have a negligible impact on state revenues.

##### Revenue Discussion

Revenue estimates were based on federal projections.

### **3. Exclusion for Amounts Received Under Department of Defense Homeowners Assistance Program.**

#### Background

The Department of Defense Homeowners Assistance Program (HAP) provides payments to certain employees and members of the Armed Forces to offset the adverse effects on housing values that result from a military base realignment or closure.<sup>1</sup>

In general, under HAP, eligible individuals receive either:

(1) a cash payment as compensation for losses that may be or have been sustained in a private sale, in an amount not to exceed the difference between

- 95% of the fair market value of their property prior to public announcement of intention to close all or part of the military base or installation, and
- the fair market value of such property at the time of the sale; or

(2) as the purchase price for their property, an amount not to exceed 90% of the prior fair market value as determined by the Secretary of Defense, or the amount of the outstanding mortgages.

#### FEDERAL/STATE TAX LAW

Unless specifically excluded, gross income for federal and state income tax purposes includes all income from whatever source derived. Amounts received under HAP are received in connection with the performance of services. These amounts are includible in gross income under prior federal law and current state law as compensation for services to the extent such payments exceed the fair market value of the property relinquished in exchange for such payments. Additionally, those payments were treated under prior federal law as wages for Federal Insurance Contributions Act (FICA) tax purposes (including Medicare).

#### New Federal Law

The provision generally exempts from gross income amounts received under the HAP (as in effect on November 11, 2003). Amounts received under the program also are not considered wages for FICA tax purposes (including Medicare). The excludable amount is limited to the reduction in the fair market value of property.

#### Effective Date

The provision is effective for payments made after November 11, 2003.

#### Current California Law

California law, as it relates to amounts received under HAP, is in conformity with federal law as it read prior to the MFTRA. The amounts are included in gross income.

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<sup>1</sup> The payments are authorized under the provisions of Title 42 U.S.C. Section 3374.

## THIS BILL

This bill would conform to the MFTRA changes to this provision. The federal provision was made effective for payments made after November 11, 2003, and this bill would make the California provision effective for the same payments.

## **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

## **ECONOMIC IMPACT**

### Revenue Estimate

Conforming to the federal exclusion of amounts received under HAP from gross income would have a negligible impact on state revenues.

### Revenue Discussion

Revenue estimates were based on federal projections.

## **4. Expansion of Combat Zone Filing Rules to Contingency Operations.**

### FEDERAL LAW

Individuals generally must file their federal income tax returns by April 15 of the year following the close of a taxable year. The Secretary may grant reasonable extensions of time for filing such returns. Treasury regulations provide an additional automatic two-month extension (until June 15 for calendar-year individuals) for United States citizens and residents in military or naval service on duty on April 15 of the following year (the otherwise applicable due date of the return) outside the United States. No action is necessary to apply for this extension, but taxpayers must indicate on their returns (when filed) that they are claiming this extension. Unlike most extensions of time to file, this extension applies to both filing returns and paying the tax due.

Treasury regulations also provide, upon application on the proper form, an automatic four-month extension (until August 15 for calendar-year individuals) for any individual timely filing that form and timely paying the amount of tax estimated to be due.

In general, individuals must make quarterly estimated tax payments by April 15, June 15, September 15, and January 15 of the following taxable year. Wage withholding is considered to be a payment of estimated taxes.

In general, the period of time for performing various acts under the Internal Revenue Code (IRC), such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, is suspended for any individual serving in the Armed Forces of the United States in an area designated as a "combat zone" during the period of combatant activities. An individual who becomes a prisoner of war is considered to continue in active service and is therefore also eligible for these suspensions of time provisions. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those forces. The President in an Executive Order must make the designation of a combat zone. The President must also designate the period of combatant activities in the combat zone (the starting date and the termination date of combat).



The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone, as well as (1) any time of continuous qualified hospitalization resulting from injury received in the combat zone<sup>2</sup> or (2) time in missing-in-action status, plus the next 180 days.

The suspension of time applies to the following acts:

- Filing any return of income, estate, or gift tax (except employment and withholding taxes);
- Payment of any income, estate, or gift tax (except employment and withholding taxes);
- Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;
- Allowance of a credit or refund of any tax;
- Filing a claim for credit or refund of any tax;
- Bringing suit upon any such claim for credit or refund;
- Assessment of any tax;
- Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;
- Collection of the amount of any liability in respect of any tax;
- Bringing suit by the United States in respect of any liability in respect of any tax; and
- Any other act required or permitted under the federal tax laws specified by the Secretary of the Treasury.

Individuals may, if they choose, perform any of these acts during the period of suspension. Spouses of qualifying individuals are entitled to the same suspension of time, except that the spouse is ineligible for this suspension for any taxable year beginning more than two years after the date of termination of combatant activities in the combat zone.

### New Federal Law

This provision applies the special suspension of time period rules to persons deployed outside the United States away from the individual's permanent duty station while participating in an operation designated by the Secretary of Defense as a contingency operation or that becomes a contingency operation by operation of law. A contingency operation is defined<sup>3</sup> as a military operation that is designated by the Secretary of Defense as an operation in which members of the Armed Forces are or may become involved in military actions, operations, or hostilities against an enemy of the United States or against an opposing military force, or results in the call or order to (or retention on) active duty of members of the uniformed services during a war or a national emergency declared by the President or Congress.

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<sup>2</sup> Two special rules apply to continuous hospitalization inside the United States. First, the suspension of time provisions based on continuous hospitalization inside the United States are applicable only to the hospitalized individual; they are not applicable to the spouse of such individual. Second, in no event do the suspension of time provisions based on continuous hospitalization inside the United States extend beyond five years from the date the individual returns to the United States. These two special rules do not apply to continuous hospitalization outside the United States.

<sup>3</sup> The definition is by cross-reference to 10 U.S.C. Section 101.

### Effective Date

The provision applies to any period for performing an act that has not expired before November 11, 2003.

### California Law

California law, as it relates to combat zone filing rules, is in conformity with federal law as it read prior to the enactment of the MFTRA.

### THIS BILL

This bill would conform to the MFTRA changes to this provision. The federal provision was made effective to any period for performing an act that has not expired before November 11, 2003, and this bill contains the same effective date for the California provision.

### **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

### **ECONOMIC IMPACT**

#### Revenue Estimate

Conforming to the federal expansion of combat zone filing rules to contingency operations would have a negligible impact on state revenues.

#### Revenue Discussion

Revenue estimates were based on federal projections.

### **5. Modification of Membership Requirements for Exemption from Tax for Certain Veterans' Organizations.**

#### FEDERAL/STATE LAW

Under prior federal law and current state law, a veteran's organization generally is exempt from taxation. The IRC defines such an organization as a post or organization of past or present members of the Armed Forces of the United States:

- (1) that is organized in the United States or any of its possessions;
- (2) no part of the net earnings of that inures to the benefit of any private shareholder or individual;  
and
- (3) that meets certain membership requirements.

The membership requirements are that:

- (1) at least 75% of the organization's members are past or present members of the Armed Forces of the United States, and
- (2) substantially all of the remaining members are cadets or spouses, widows, or widowers of past or present members of the Armed Forces of the United States or of cadets.

No more than 25% of an organization's total members may consist of individuals who are not veterans, cadets, or spouses, widows, or widowers of such individuals.

Contributions to a veteran's organization may be deductible for federal and state income or federal gift tax purposes if the organization is a post or organization of war veterans.

#### New Federal Law

The provision permits ancestors or lineal descendants of past or present members of the Armed Forces of the United States or of cadets to qualify as members for purposes of the "substantially all" test. The bill does not change the requirement that 75% of the organization's members must be past or present members of the Armed Forces of the United States.

#### Effective Date

The provision is effective for taxable years beginning after November 11, 2003.

#### California Law

California law, as it relates to veterans' organizations, is in conformity with federal law as it read prior to the enactment of the MFTRA.

#### THIS BILL

This bill would conform to the MFTRA changes to this provision. The federal provision was made effective for taxable years beginning after November 11, 2003, and this bill would make the California provision effective for the same periods.

#### **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

#### **ECONOMIC IMPACT**

##### Revenue Estimate

Conforming to the federal modification of membership requirement for exemption from tax for certain veterans' organizations would have a negligible impact on state revenues.

##### Revenue Discussion

Revenue estimates were based on federal projections.

#### **6. Clarification of Treatment of Certain Dependent Care Assistance Programs Provided to Members of the Uniformed Services of the United States.**

##### FEDERAL/STATE LAW

Prior federal and current state laws provide that qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) that: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as

a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice that was in effect on such date. Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income.

#### New Federal Law

The provision clarifies that dependent care assistance provided under a dependent care assistance program (as in effect on November 11, 2003) for a member of the uniformed services by reason of such member's status or service as a member of the uniformed services is excludable from gross income as a qualified military benefit subject to the present-law rules. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. Amounts received under the program also are not considered wages for FICA tax purposes (including Medicare).

#### Effective Date

The provision is effective for taxable years beginning after December 31, 2002. No inference is intended as to the tax treatment of such amounts for prior taxable years.

#### California Law

California law, as it relates to the treatment of certain dependent care assistance programs provided to members of the uniformed services, is in conformity with federal law prior to the enactment of the MFTRA.

#### THIS BILL

This bill would conform to the MFTRA changes to this provision. The federal provision was made effective for taxable years beginning after December 31, 2002, and contained language stating that no inference was to be drawn from the change with respect to taxable years beginning before January 1, 2003. This bill would make the California provision effective for the same periods and contains the same "no inference" language.

#### **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

#### **ECONOMIC IMPACT**

##### Revenue Estimate

Conforming to the federal clarification of treatment of certain dependent care assistance programs provided to members of the uniformed services would not impact state revenues.

## **7. Treatment of Service Academy Appointments as Scholarships for Purposes of Qualified Tuition Programs and Coverdell Education Savings Accounts.**

### FEDERAL/STATE LAW

Federal and state law provide tax-exempt status to qualified tuition programs, meaning programs established and maintained by a state or agency or instrumentality thereof or by one or more eligible educational institutions under which a person (1) may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary, or (2) in the case of a program established by and maintained by a state or agency or instrumentality thereof, may make contributions to an account that is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account. Contributions to qualified tuition programs may be made only in cash. Qualified tuition programs must have adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of amounts necessary to provide for the qualified higher education expenses of the beneficiary.

Federal and state law also provide tax-exempt status to Coverdell education savings accounts (ESAs), meaning certain trusts or custodial accounts that are created or organized in the United States exclusively for the purpose of paying the qualified education expenses of a designated beneficiary. Contributions to ESAs may be made only in cash. Annual contributions to ESAs may not exceed \$2,000 per beneficiary (except in cases involving certain tax-free rollovers) and may not be made after the designated beneficiary reaches age 18.

Earnings on contributions to an ESA or a qualified tuition program generally are subject to tax when withdrawn. However, distributions from an ESA or qualified tuition program are excludable from the gross income of the distributee to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made.

If the qualified education expenses of the beneficiary for the year are less than the total amount of the distribution from an ESA or qualified tuition program, then the qualified education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. In such a case, only a portion of the earnings is excludable (i.e., the portion of the earnings based on the ratio that the qualified education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary's gross income.

The earnings portion of a distribution from an ESA or a qualified tuition program that is includible in income is generally subject to an additional federal 10% (2 ½% for California) tax. The additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary (to the extent it does not exceed the amount of the scholarship).

Service obligations are required of recipients of appointments to the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy. Because of these service obligations, appointments to the Academies are not considered scholarships for purposes of IRC Section 117 (which provides that scholarships are excludable from gross income subject to tax). The Joint Committee on Taxation has concluded appointments to the Academies are not considered scholarships for purposes of the waiver of the additional tax on withdrawals from ESAs and qualified tuition programs that are not used for qualified education purposes. However, the Office of Chief Counsel, Internal Revenue Service, has concluded that appointments to the Academies may be considered scholarships for purposes of the waiver of the additional tax on withdrawals.

### New Federal Law

Under the provision, the additional federal 10% tax does not apply to withdrawals from ESAs and qualified tuition programs made on account of the attendance of the beneficiary at the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy.

The amount of funds that can be withdrawn without payment of the 10% additional federal tax is limited to the costs of advanced education as defined in Title 10 U.S.C. Section 2005(e)(3) (as in effect on November 11, 2003) at such Academies.

### Effective Date

The provision applies to taxable years beginning after December 31, 2002.

### California Law

California law, as it relates to qualified tuition programs and ESAs, generally conforms to federal law as it read prior to the enactment of the MFTRA. California law imposes a 2½% additional tax rather than the 10% additional federal tax on distributions that must be included in gross income.

### THIS BILL

This bill would conform to the MFTRA changes to this provision. The federal provision was made effective for taxable years beginning after December 31, 2002, and this bill would make the California provision effective for the same periods.

### **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

### **ECONOMIC IMPACT**

#### Revenue Estimate

Conforming to the federal treatment of qualified tuition programs and ESAs would have a negligible impact on state revenues.

#### Revenue Discussion

Revenue estimates were based on federal projections.

## **8. Suspension of Tax-Exempt Status of Terrorist Organizations.**

### FEDERAL/STATE LAW

Under federal law prior to the enactment of the MFTRA, the IRS generally issued a letter revoking recognition of an organization's tax-exempt status only after (1) conducting an examination of the organization, (2) issuing a letter to the organization proposing revocation, and (3) allowing the organization to exhaust the administrative appeal rights that follow the issuance of the proposed revocation letter. In the case of an organization described in IRC Section 501(c)(3), the revocation letter immediately would be subject to judicial review under the declaratory judgment procedures of IRC Section 7428. To sustain a revocation of tax-exempt status under IRC Section 7428, the IRS must demonstrate that the organization is no longer entitled to exemption. There was no procedure for the IRS to suspend the tax-exempt status of an organization.

To combat terrorism, the federal government has designated a number of organizations as terrorist organizations or supporters of terrorism under the Immigration and Nationality Act, the International Emergency Economic Powers Act, and the United Nations Participation Act of 1945.

### New Federal Law

The provision suspends the tax-exempt status of an organization that is exempt from tax under IRC Section 501(a) for any period during which the organization is designated or identified by U.S. federal authorities as a terrorist organization or supporter of terrorism. The act also makes such an organization ineligible to apply for tax exemption under IRC Section 501(a). The period of suspension runs from the date the organization is first designated or identified (or from November 11, 2003, whichever is later) to the date when all designations or identifications with respect to the organization have been rescinded pursuant to the law or Executive Order under which the designation or identification was made.

The provision describes a terrorist organization as an organization that has been designated or otherwise individually identified (1) as a terrorist organization or foreign terrorist organization under the authority of Section 212(a)(3)(B)(vi)(II) or Section 219 of the Immigration and Nationality Act; (2) in or pursuant to an Executive Order that is related to terrorism and issued under the authority of the International Emergency Economic Powers Act or Section 5 of the United Nations Participation Act for the purpose of imposing on such organization an economic or other sanction; or (3) in or pursuant to an Executive Order that refers to the provision and is issued under the authority of any federal law if the organization is designated or otherwise individually identified in or pursuant to such Executive Order as supporting or engaging in terrorist activity (as defined in Section 212(a)(3)(B) of the Immigration and Nationality Act) or supporting terrorism (as defined in Section 140(d)(2) of the Foreign Relations Authorization Act, Fiscal Years 1988 and 1989). During the period of suspension, no deduction for any contribution to a terrorist organization is allowed under the IRC, including under IRC Sections 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

No organization or other person may challenge, under IRC Section 7428 or any other provision of law, in any administrative or judicial proceeding relating to the federal tax liability of such organization or other person, the suspension of tax exemption, the ineligibility to apply for tax exemption, a designation or identification described above, the timing of the period of suspension, or a denial of deduction described above. The suspended organization may maintain other suits or administrative actions against the agency or agencies that designated or identified the organization, for the purpose of challenging such designation or identification (but not the suspension of tax-exempt status under this provision).

If the tax exemption of an organization is suspended and each designation and identification that has been made with respect to the organization is determined to be erroneous pursuant to the law or Executive Order making the designation or identification, and such erroneous designation results in an overpayment of income tax for any taxable year with respect to such organization, a credit or refund (with interest) with respect to such overpayment shall be made. If the operation of any law or rule of law (including res judicata) prevents the credit or refund at any time, the credit or refund may nevertheless be allowed or made if the claim for such credit or refund is filed before the close of the one-year period beginning on the date that the last remaining designation or identification with respect to the organization is determined to be erroneous.

The provision directs the IRS to update the listings of tax-exempt organizations to take account of organizations that have had their exemption suspended and to publish notice to taxpayers of the suspension of an organization's tax-exemption and the fact that contributions to such organization are not deductible during the period of suspension.

#### Effective Date

The provision is effective for designations made before, on, or after November 11, 2003.

#### California Law

California law conforms to federal law regarding exempt organizations with modifications and exceptions. California law does not contain statutes regarding the suspending or revoking of an organization's tax-exemption due to terrorist activities.

#### THIS BILL

This bill would conform to the MFTRA changes to this provision. The federal provision was made effective for designations made before, on, or after November 11, 2003, and this bill would make the California provision effective for the same periods. However, this bill provides that this provision only applies where the federal exemption is suspended and only during the time of the federal suspension.

#### **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

#### **ECONOMIC IMPACT**

##### Revenue Estimate

Conforming to the federal suspension of tax-exempt status of terrorist organizations would have a negligible impact on state revenues.

##### Revenue Discussion

Revenue estimates were based on federal projections.



## **9. Above-the-Line Deduction for Overnight Travel Expenses of National Guard and Reserve Members.**

### FEDERAL/STATE LAW

Under prior federal law and current state law National Guard and Reserve members may claim itemized deductions for their nonreimbursable expenses for transportation, meals, and lodging when they must travel away from home (and stay overnight) to attend National Guard and Reserve meetings. These overnight travel expenses are combined with other miscellaneous itemized deductions on Schedule A of the individual's income tax return and are deductible only to the extent that the aggregate of these deductions exceeds 2% of the taxpayer's AGI. No deduction is generally permitted for commuting expenses to and from drill meetings.

### New Federal Law

The provision allows an above-the-line deduction for the overnight transportation, meals, and lodging expenses of National Guard and Reserve members who must travel away from home more than 100 miles (and stay overnight) to attend National Guard and Reserve meetings. Accordingly, these individuals incurring these expenses can deduct them from gross income regardless of whether they itemize their deductions. The amount of the expenses that may be deducted may not exceed the general federal government per diem rate applicable to that locale. Also, the amount of the expenses that may be deducted is only available for any period during which the individual is more than 100 miles from home in connection with such services.

### Effective Date

The provision is effective with respect to amounts paid or incurred in taxable years beginning after December 31, 2002.

### California Law

California law, as it relates to the deduction of trade or business expenses and employee nonreimbursable expenses, is in conformity with federal law as it read prior to the enactment of the MFTRA.

### THIS BILL

This bill would conform to the MFTRA changes to this provision. The federal provision was made effective for amounts paid or incurred in taxable years beginning after December 31, 2002, and this bill would make the California provision effective for the same amounts in the same periods.

## **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

## ECONOMIC IMPACT

### Revenue Estimate

Estimated Revenue Impact of Above-the-Line Deduction for Overnight Travel Expense of National Guard and Reserve Members For Amounts Paid Or Incurred After December 31, 2002 (\$ Millions)			
Fiscal Year	2004-05	2005-06	2006-07
Revenue Loss	-2.5	-2.3	-2.3

### Revenue Discussion

Revenue estimates were based on federal projections.

## 10. Extension of Certain Tax Relief Provisions to Astronauts

### FEDERAL/STATE LAW

#### *In general*

Under federal and state law the Victims of Terrorism Tax Relief Act of 2001 (the "Victims Act") provided certain income and estate tax relief to individuals who die from wounds or injury incurred as a result of the terrorist attacks against the United States on September 11, 2001, and April 19, 1995, (the bombing of the Alfred P. Murrah Federal Building in Oklahoma City) or as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002.

#### *Income tax relief*

The Victims Act extended relief similar to the present-law treatment of military or civilian employees of the United States who die as a result of terrorist or military activity outside the United States to individuals who die as a result of wounds or injury that were incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, and individuals who die as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002. Under the Victims Act, such individuals generally are exempt from income tax for the year of death and for prior taxable years beginning with the taxable year prior to the taxable year in which the wounds or injury occurred.<sup>4</sup> The exemption applies to these individuals whether killed in an attack (e.g., in the case of the September 11, 2001, attack in one of the four airplanes or on the ground) or in rescue or recovery operations.

Current federal law (to which California did not conform) also provides tax relief of at least \$10,000 to each eligible individual regardless of the income tax liability of the individual for the eligible tax years. If an eligible individual's income tax for years eligible for the exclusion under the provision is less than \$10,000, the individual is treated as having made a tax payment for such individual's last taxable year in an amount equal to the excess of \$10,000 over the amount of tax not imposed under the provision.

<sup>4</sup> Present law does not provide relief from self-employment tax liability.

Under regulations, the exemption from tax does not apply to the tax attributable to (1) deferred compensation that would have been payable after death if the individual had died other than as a specified terrorist victim, or (2) amounts payable in the taxable year that would not have been payable in such taxable year but for an action taken after September 11, 2001. Thus, for example, the exemption does not apply to amounts payable from a qualified plan or individual retirement arrangement to the beneficiary or estate of the individual. Similarly, amounts payable only as death or survivor's benefits pursuant to deferred compensation preexisting arrangements that would have been paid if the death had occurred for another reason are not covered by the exemption. In addition, if the individual's employer makes adjustments to a plan or arrangement to accelerate the vesting of restricted property or the payment of nonqualified deferred compensation after the date of the particular attack, the exemption does not apply to income received as a result of that action.<sup>5</sup> Also, if the individual's beneficiary cashed in savings bonds of the decedent, the exemption does not apply. On the other hand, the exemption does apply, for example, to a final paycheck of the individual or dividends on stock held by the individual when paid to another person or the individual's estate after the date of death but before the end of the taxable year of the decedent (determined without regard to the death). The exemption also applies to payments of an individual's accrued vacation and accrued sick leave.

The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

#### *Exclusion of death benefits*

Under federal and state law the Victims Act generally provides an exclusion from gross income for amounts received if such amounts are paid by an employer (whether in a single sum or otherwise<sup>6</sup>) by reason of the death of an employee who dies as a result of wounds or injury that were incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002. Subject to regulations, the exclusion does not apply to amounts that would have been payable if the individual had died for a reason other than the attack. The exclusion does apply, however, to death benefits provided under a qualified plan that satisfy the incidental benefit rule.

For purposes of the exclusion, self-employed individuals are treated as employees. Thus, for example, payments by a partnership to the surviving spouse of a partner who died as a result of the September 11, 2001, attacks may be excludable under the provision.

The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

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<sup>5</sup> Such amounts may, however, be excludible from gross income under the death benefit exclusion provided in Section 102 of the Victims Act.

<sup>6</sup> Thus, for example, payments made over a period of years could qualify for the exclusion.

*Estate tax relief*

Current federal law provides a reduction in federal estate tax for taxable estates of U.S. citizens or residents who are active members of the U.S. Armed Forces and who are killed in action while serving in a combat zone (IRC Section 2201). This provision also applies to active service members who die as a result of wounds, disease, or injury suffered while serving in a combat zone by reason of a hazard to which the service member was subjected as an incident of such service.

In general, the effect of IRC Section 2201 is to replace the federal estate tax that would otherwise be imposed with a federal estate tax equal to 125% of the maximum state death tax credit determined under IRC Section 2011(b). Credits against the tax, including the unified credit of IRC Section 2010 and the state death tax credit of Section 2011, then apply to reduce (or eliminate) the amount of the estate tax payable.

Generally, the reduction in federal estate taxes under IRC Section 2201 is equal in amount to the "additional estate tax." The additional estate tax is the difference between the federal estate tax imposed by IRC Section 2001 and 125% of the maximum state death tax credit determined under IRC Section 2011(b) as in effect prior to its repeal by the Economic Growth and Tax Revenue Reconciliation Act (EGTRRA) (P.L. 107-16).

The Victims Act generally treats individuals who die from wounds or injury incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002, in the same manner as if they were active members of the U.S. Armed Forces killed in action while serving in a combat zone or dying as a result of wounds or injury suffered while serving in a combat zone for purposes of IRC Section 2201. Consequently, the estates of these individuals are eligible for the reduction in federal estate tax provided by IRC Section 2201. The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

The Victims Act also changed the general operation of IRC Section 2201, as it applies to both the estates of service members who qualify for special estate tax treatment under present and prior law and to the estates of individuals who qualify for the special treatment only under the act. Under the Victims Act, the federal estate tax is determined in the same manner for all estates that are eligible for federal estate tax reduction under IRC Section 2201. In addition, the executor of an estate that is eligible for special estate tax treatment under IRC Section 2201 may elect not to have IRC Section 2201 apply to the estate. Thus, in the event that an estate may receive more favorable treatment without the application of IRC Section 2201 in the year of death than it would under IRC Section 2201, the executor may elect not to apply the provisions of IRC Section 2201, and the estate tax owed (if any) would be determined pursuant to the generally applicable rules.

Under the Victims Act, IRC Section 2201 no longer reduces federal estate tax by the amount of the additional estate tax. Instead, the Victims Act provides that the federal estate tax liability of eligible estates is determined under IRC Section 2001 (or IRC Section 2101, in the case of decedents who were neither residents nor citizens of the United States), using a rate schedule that is equal to 125% of the pre-EGTRRA maximum state death tax credit amount. This rate schedule is used to compute the tax under IRC Section 2001(b) or Section 2101(b) (i.e., both the tentative tax under IRC Section 2001(b)(1) and Section 2101(b), and the hypothetical gift tax under IRC Section 2001(b)(2) are computed using this rate schedule). As a result of this provision, the estate tax is unified with the gift tax for purposes of IRC Section 2201 so that a single graduated (but reduced) rate schedule applies to transfers made by the individual at death, based upon the cumulative taxable transfers made both during lifetime and at death.

In addition, while the Victims Act provides an alternative reduced rate table for purposes of determining the tax under IRC Section 2001(b) or Section 2101(b), the amount of the unified credit nevertheless is determined as if IRC Section 2201 did not apply, based upon the unified credit as in effect on the date of death. For example, in the case of victims of the September 11, 2001, terrorist attack, the applicable unified credit amount under IRC Section 2010(c) would be determined by reference to the actual IRC Section 2001(c) rate table.

### New Federal Law

The provision extends the exclusion from income tax, the exclusion for death benefits, and the estate tax relief available under the Victims Act, to astronauts who lose their lives on a space mission (including the individuals who lost their lives in the space shuttle Columbia disaster).

### Effective Date

The provision is generally effective for qualified individuals whose lives are lost in the line of duty after December 31, 2002.

### California Law

California law conforms with the federal Victims Act as enacted on January 23, 2002. However, California did not conform to the provision that provides tax relief of at least \$10,000 to each eligible individual regardless of the income tax liability of the individual for the eligible tax years. In addition, California does not conform to the federal estate tax but instead imposes a state estate tax equal to the maximum credit allowed on the federal estate tax return for state estate taxes (commonly called the "pick-up" tax).

### THIS BILL

This bill would conform to the MFTRA changes to this provision except as it relates to the estate tax. The federal provision was made effective for qualified individuals whose lives are lost in the line of duty after December 31, 2002, and this bill would make the California provision effective for the same individuals in the same periods.

### **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

### **ECONOMIC IMPACT**

#### Revenue Estimate

Conforming to the federal extension of certain tax relief provisions to astronauts would have a negligible impact on state revenues.

#### Revenue Discussion

Revenue estimates were based on federal projections.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 1713  
As Introduced February 20, 2004

AMENDMENT 1

On page 2, line 10, after "Section 162" insert:  
  
of the Internal Revenue Code

AMENDMENT 2

On page 13, line 19, after "SEC. 13." insert:

The Legislature declares that this act is necessary for the public purpose of making state law the same as the federal Military Family Tax Relief Act of 2003 (Public Law 108-121) that was enacted on November 11, 2003, that specifically provides for retroactive relief.

SEC. 14.